INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Specification of errors to be urged	4
Summary of argument	4
Argument	5
Conclusion	16
Appendix	17

CITATIONS

Cases:	
Bonded Mortgage Co. v. *Commissioner*, 70 F. (2d) 341	9
Chicago, R. I. & P. Ry. Co. v. *Commissioner*, 13 B. T. A. 988, 47 F. (2d) 990, certiorari denied, 284 U. S. 618	8, 11
New York, C. & St. L. R. Co. v. *Burnet*, 64 F. (2d) 152	12
Old Colony R. Co. v. *Commissioner*, 284 U. S. 552	6, 10, 11, 12, 15
Tait v. *Western Maryland Ry. Co.*, 62 F. (2d) 933, affirmed, 289 U. S. 620	11, 12
Western Maryland Ry. Co. v. *Commissioner*, 33 F. (2d) 695	11
Statutes:	
Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, Sec. 234	17
Revenue Act of 1921, c. 136, 42 Stat. 227, 254, Sec. 234	17
Miscellaneous:	
Accounting, Practice and Procedure, by Arthur Lowes Dickinson, pp. 66, 134	15
Accounting, Theory and Practice, by Roy B. Kester, Vol. II (2d ed.), pp. 367–368	15
Accounts in Theory and Practice, by Earl A. Saliers, pp. 171–172	15
I. T. 1412, I–2 Cumulative Bulletin 91	9
I. T. 1962, III–1, Cumulative Bulletin 291	9
Modern Accounting, by Henry Rand Hatfield, pp. 187–188	15
O. D. 936, 4 Cumulative Bulletin 276	9
O. D. 959, 4 Cumulative Bulletin 129	9
S. M. 3691, IV–1 Cumulative Bulletin 145	9
Treasury Regulations 33, Art. 150	7
Treasury Regulations 45, Art. 544	17
Treasury Regulations 62, Art. 545	17
Treasury Regulations 65, Art. 545	9
Treasury Regulations 69, Art. 545	9
Treasury Regulations 74, Art. 68	9
Treasury Regulations 77, Art. 68	18

In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 51

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

UNION PACIFIC RAILROAD COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 41) is reported in 26 B. T. A. 1126. The opinion of the Circuit Court of Appeals (R. 97) is reported in 69 F. (2d) 67. The part of the opinion of the Board of Tax Appeals dealing with the question here sought to be reviewed commences at R. 52 and that of the Circuit Court of Appeals at R. 101.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 20, 1934 (R. 103). A petition of the taxpayer for rehearing was denied

March 14, 1934 (R. 105). The petition for certiorari was filed May 19, 1934, and granted October 8, 1934. The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer kept its books on the accrual basis, and it and the Oregon Short Line Railroad Company made consolidated returns. The taxpayer and the Oregon Short Line had both marketed issues of bonds prior to 1913, and in that connection had incurred and paid commissions to bankers. May the current year's proportion of the amortization of these commissions be subtracted in determining taxable net income in 1920, 1921, 1922, and 1923?

STATUTES AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra,* pp. 17–18.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 52) may be summarized as follows:

Prior to 1913 the Union Pacific Railroad Company and its subsidiary, the Oregon Short Line, sold three issues of bonds at varying rates of discount, and in connection with the sales paid commissions to bankers. The railroads claimed deductions in the taxable years 1920, 1921, 1922, and 1923 for these discounts and commissions, amortized over the life of the bonds. The aggregate amount of the deductions claimed each year on account of

discounts was $251,896.55, and on account of commissions, $57,252.57 (R. 52). The issues of bonds, the commissions paid, and the amortization of commissions, as shown by the petition to the Board of Tax Appeals, the allegations of which on this point were admitted by the answer (R. 82), were as follows:

In 1904 the Oregon Short Line sold an issue of Refunding bonds maturing on December 1, 1929, upon which it paid commissions amounting to $960,000, which, amortized over the twenty-five-year life of the bonds, gives $38,400 as the yearly amortization of commissions (R. 23–24).

In 1907 the Union Pacific sold an issue of Twenty-Year Convertible bonds upon which it paid commissions amounting to $134,176, which amortized over the twenty-year life of the bonds, gives $6,708.80 as the yearly amortization of the commissions (R. 19–20).

In 1908 the Union Pacific sold an issue of First Lien and Refunding bonds maturing in 2008, upon which it paid commissions amounting to $1,214,377.16, which, amortized over the one-hundred-year life of the bonds, gives $12,143.77 as the yearly amortization of the commissions (R. 21).

The Board of Tax Appeals decided that the taxpayer was entitled to the deductions claimed on account of bond discount, but not on account of commissions (R. 53). As to the commissions, the taxpayer appealed to the Circuit Court of Appeals, which reversed the Board of Tax Appeals (R. 101–103).

SPECIFICATION OF ERRORS TO BE URGED

1. The Circuit Court of Appeals erred in holding that the taxpayer could deduct the amortized commissions on bonds issued prior to 1913.

2. The Circuit Court of Appeals erred in holding that the commissions paid on bonds issued prior to 1913 are losses within the meaning of Section 234 (a) (4) of the Revenue Acts of 1918 and 1921, that they will not be suffered until the bonds mature, and that they may be amortized over the life of the bonds.

3. The Circuit Court of Appeals erred in reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

There is no provision in the statute or the regulations permitting the amortization and deduction of commissions on bonds issued prior to 1913. There was formerly such a provision in the Treasury Regulations, but it was omitted in the regulations from 1918 on. In the absence of a provision in the statute or in the regulations expressly granting the right to make the deduction, the taxpayer is not entitled to it.

As to bonds issued after 1913, the Treasury Department permits taxpayers to amortize and deduct commissions, as well as other expenses incidental to the sale of bonds. This right is not derived from the statute or the regulations, which are silent as to commissions, but is granted as a matter of administrative practice. There are a number

of published rulings confirming this practice. As to premiums and discount on bonds issued after 1913, the Treasury Regulations expressly authorize the amortization of these items over the life of the bonds. Therefore premiums, discount, and commissions, all of which are generally similar and relate to the obtaining of new capital, are treated alike.

As to premiums and discount on bonds issued before 1913, the Treasury Regulations formerly authorized the amortization of both premiums and discount. About two years ago, however, this Court held that the part of the regulations which required the amortization of premiums was invalid. The Treasury Department has continued to permit the amortization of discount, although the new regulations expressly provide that premiums need not be amortized. It is anomalous and unreasonable to treat premiums in one way and discount in another. Therefore the regulations are incorrect in so far as they fail to eliminate the amortization of discount as well as of premiums. Conceding that commissions and other expenses are analogous to discount and premiums, in order to attain uniformity of treatment for premiums, discount, and commissions on bonds issued before 1913, it is proper that they likewise should not be amortized.

ARGUMENT

The commissions sought to be amortized in this case were paid prior to March 1, 1913, and we sub-

mit that in this respect the question presented is similar to the amortization of premiums. In *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, this Court settled the proposition that premiums on bonds issued prior to March 1, 1913, are not the proper subject of amortization, from which we think it follows that commissions on bonds issued prior to March 1, 1913, should not be amortized.

Section 234 of the Revenue Acts of 1918 and 1921, *infra,* p. 17, like corresponding provisions of the Acts before and since, allowed deduction of expenses paid or incurred, interest paid or accrued, and losses sustained, during the taxable year. These commissions, whether regarded as expenses, extra interest, or losses, were incurred and paid in 1904, 1907, and 1908, and it is only by a fiction of accounting that any part of them can be regarded as falling in any of the years 1920 to 1923. Furthermore, there is no provision in Treasury Regulations 45, relating to the Revenue Act of 1918, or in Treasury Regulations 62, relating to the Revenue Act of 1921, which permits the deduction of commissions paid for the sale of bonds and the amortization of such amounts over the life of the bonds. In the absence of a provision in the statute or in the regulations expressly granting the right to make the deduction, the taxpayer is not entitled to it.

The court below recognized the difficulty of finding some support in the statute for the deduction. The court said (R. 102):

It is not easy to select the precise provision of the statute which authorizes amortization and deduction either of bond discount or bond commissions. The petitioner has not attempted to pin its flag to a single specific phrase. Section 234 is the relevant section in both the Revenue Act of 1918 (40 Stat. 1077) and the Revenue Act of 1921 (42 Stat. 254). Separate paragraphs authorize the deduction from gross income of "ordinary and necessary expenses paid or incurred during the taxable year", of "interest paid or accrued", of "losses sustained", and of depreciation and exhaustion. Bond discount and commissions scarcely fall within the first category; they represent the cost of acquiring new capital, rather than an ordinary and necessary expense in carrying on business during the year. Discount is often referred to as deferred interest, and deduction of amortized discount has been allowed under the "interest" paragraph. See *Western Maryland* case, *supra*. To us the "loss sustained" paragraph seems the more appropriate.

There is only one other court decision dealing with the right to deduct expenses in connection with the sale of bonds issued prior to 1913.[1] In

[1] Under Article 150 of Treasury Regulations 33, relating to the Revenue Act of 1916, taxpayers were expressly permitted to amortize and deduct commissions, as well as discount. Treasury Regulations 45 and 62 and all later regulations continued the right to deduct discount but omitted any reference to commissions and other expenses incidental

Chicago, R. I. & P. Ry. Co. v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7th), certiorari denied, 284 U. S. 618, the taxpayer sold prior to 1913 bonds maturing in 1934. The expenses of selling the bonds, which amounted to about $250,000, were charged to profit and loss on the dates of sale. The taxpayer claimed a *pro rata* expense deduction for the years 1916 to 1919, inclusive, for the cost of issuing and selling the bonds, but the court held that the taxpayer was not entitled to the deduction. While the precise nature of the expenses and whether they included commission does not appear, the general nature of the expenses was similar to those involved in the present case. The principle which controlled that case is the one which we invoke here, namely, that since premiums on bonds sold prior to March 1, 1913, could not be prorated over the life of the bonds, it follows that expenses incurred and charged off prior to March 1, 1913, should not be allowed as deductions from income in subsequent years.

There is a recent decision which holds that commissions paid for the sale of a taxpayer's bonds issued after 1913 may be deducted as an ordinary

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to issuing bonds. Nevertheless, it appears that the Commissioner in fact continued to permit taxpayers to amortize and deduct commissions on bonds issued prior to 1913 under the conditions of Article 150 of Treasury Regulations 33 until the decision of the Board of Tax Appeals in *Chicago, R. I. & P. Ry Co.* case, 13 B. T. A. 988, 1034. After that decision the practice of the Commissioner was not to permit the amortization of commissions on bonds issued before 1913.

and necessary expense of the business in the year that the bonds are issued, and that the Commissioner may not require the taxpayer to amortize the amount of the commissions over the life of the bonds. *Bonded Mortgage Co.* v. *Commissioner,* 70 F. (2d) 341 (C. C. A. 4th). That case concerned commissions on the sale of bonds issued after 1913,[2] and the court recognized that the decision was an exception to the general rule and applied only under the peculiar circumstances of that case.

The court below, however, reached the conclusion that these commissions were a loss within the meaning of the statute.

The reasoning to sustain the deduction of commissions as a loss seems wholly artificial. A commission paid to bankers for floating an issue of securities is not a loss in any ordinary sense. It is a sum of money paid for services, which presumably are worth the amount paid. Such expenses are incurred when the services are rendered, and paid when the services are paid for, not twenty or

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[2] With respect to bonds issued after 1913, the Treasury Regulations have been silent as to commissions. Treasury Regulations 45, Article 544; Treasury Regulations 62, 65, and 69, Article 545; Treasury Regulations 74 and 77, Article 68. But there are a number of Treasury rulings which permit the amortization and deduction of commissions on bonds issued after 1913. O. D. 936, 4 Cumulative Bulletin 276; O. D. 959, 4 Cumulative Bulletin 129; I. T. 1412, I–2 Cumulative Bulletin 91; I. T. 1962, III–1 Cumulative Bulletin 291; S. M. 3691, IV–1 Cumulative Bulletin 145.

a hundred years thereafter when the securities mature. If the view taken by the court below in this respect were followed, then an issuer of bonds, who afterwards became insolvent and never paid them off, would be regarded as never having paid the commissions which it actually did pay when the bonds were issued.

As to that part of the reasoning of the court below to the effect that commissions should be treated on the same basis as bond discount, we are inclined to agree. In fact, we believe that premiums, as well as discount and commissions, are all similar and should all be treated alike. Since they are incidental to the obtaining of new capital, they are not properly to be regarded as falling entirely in the year in which they occur. In the case of bonds issued after 1913, the Treasury Regulations provide for the amortization of premiums and discount, and the administrative practice and published rulings permit the amortization of bond commissions and other expenses incident to the sale of bonds.[3]

But in the case of bonds issued prior to 1913 there is no such uniform treatment of premiums and discount and commissions. Formerly the Treasury Regulations made no distinction as to premiums and discount between bonds issued prior to 1913 and those issued after that date. In *Old Colony R. Co.* v. *Commissioner, supra,* this Court

[3] See note 2, *supra.*

held inapplicable the part of the regulations [4] dealing with amortization of premiums upon bonds issued prior to 1913 because the regulations expressly provided that the net amount of premium is gain or income and the taxpayer received the premiums prior to the adoption of the Sixteenth Amendment. Previously it had been held by the Board of Tax Appeals [5] and the Circuit Court of Appeals for the Fourth Circuit [6] that discount on bonds issued prior to 1913 must be prorated. After the decision in the *Old Colony* case Treasury Regulations 77, relating to the Revenue Act of 1932, were promulgated. Article 68, *infra,* p. 18, provided that premiums on bonds issued after 1913 should be amortized and returned as income; discount should be amortized and deductible, without any reference to when the bonds were issued; and premiums on bonds issued prior to 1913 should not be amortized.[7]

In *Tait* v. *Western Maryland Ry. Co.,* 62 F. (2d) 933 (C. C. A. 4th), the Government sought to raise the question whether the provision of the regula-

[4] Article 545 of Treasury Regulations 62, relating to the Revenue Act of 1921.

[5] *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 13 B. T. A. 988, 1027–1034.

[6] *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695, 696–697.

[7] The earlier regulations have not been amended so as to distinguish between premiums on bonds issued prior to 1913 and those on bonds issued after 1913, but the practice of the Treasury Department is to amortize premiums only when the bonds were issued after 1913, in conformity with the rule laid down by this Court in the *Old Colony* case.

tions relating to discount on bonds issued prior to 1913 was affected by the decision of this Court in the *Old Colony* case, *supra*. The court found it unnecessary to pass upon the question, but queried (p. 934) whether premiums and discount should not be treated alike.

The Government abandoned the question of bond discount when the case was presented to this Court. 289 U. S. 620. In another case which was submitted after the decision of this Court in the *Old Colony* case, the Government did not raise the question of discount on bonds issued prior to 1913 and the court assumed the correctness of the regulations. *New York, C. & St. L. R. Co.* v. *Burnet,* 64 F. (2d) 152, 154 (App. D. C.). In the instant case the Board of Tax Appeals decided that the taxpayer could deduct the amortized discount on bonds issued prior to 1913 (R. 52–53) and the Commissioner did not raise the question in the court below. There have been no decisions in the courts as to the right to deduct discount on bonds issued prior to 1913, since the decision of this Court in the *Old Colony* case, and inasmuch as the Treasury Department permits taxpayers to continue to deduct discount on bonds issued prior to 1913 the question is not likely to arise.

The inconsistency of the Treasury regulations with respect to bonds issued prior to 1913 is brought into sharp relief by the facts of this case. Not only do the regulations permit the taxpayer to de-

duct discount whereas the practice of the Department does not permit the deduction of commissions, but the taxpayer has been permitted to deduct some of the commissions and not others. Those commissions which were paid to the bankers for bonds that they were obliged to take in accordance with the underwriting agreement were treated like discount, which the Board decided that the taxpayer could deduct and the Commissioner did not appeal. But commissions that were paid to the bankers for selling the bonds to other persons were held not deductible by the Board and the Commissioner.[8] The

[8] The detailed facts in this connection as shown by the amended petition in the Board of Tax Appeals, the allegations of which on this point were admitted in the answer (R. 41), were substantially as follows:

As to the convertible bonds.—This issue was made by the Union Pacific in 1907 and offered to its stockholders for pro rata subscription at $90. A firm of bankers formed an underwriting syndicate to guarantee the sale of the bonds at that price, and the railroad undertook to pay a commission of 2 percent to the syndicate and a commission of one-half of 1 percent to the syndicate managers. The stockholders of the railroad took only a few of the bonds, and the syndicate took up the issue under its guarantee, paying the subscription price of $90 less the commission of 2 percent. This 2 percent commission was treated as discount, and is included in the amortization of discounts allowed by the Board of Tax Appeals and from which the Commissioner did not appeal (R. 19–20, 52). The other one-half of 1 percent commission paid to the syndicate managers amounted to $134,176, which, amortized over the life of the bonds, gives $6,708.80 per annum, which is the amount mentioned in the findings of the Board of Tax Appeals (R. 19–20, 52). It is only this syndicate managers' commission

Commissioner's action amounts to a tacit admission that the distinction between discounts and commissions is tenuous and elusive.

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of one-half of 1 per cent, therefore, which is presently in issue.

As to the first lien and refunding bonds.—These bonds "were sold to the public by a firm of bankers for the account of said petitioner at the price of 95½, said bankers receiving a commission of 2½ percent" (R. 21). This commission amounted to $1,214,377.16, which amortized over the one hundred year life of the bonds gives as annual amortization $12,143.77, which is the amount mentioned in the findings of the Board of Tax Appeals (R. 21, 52).

As to the Oregon Short Line refunding bonds.—$40,000,000 of these bonds were issued, and were offered to the holders of maturing bonds, at $96. A firm of bankers formed a syndicate to guarantee the sale of the 40 million of bonds at 96, and the railroad agreed to pay commissions of 2 percent to the syndicate and 1 percent to the syndicate managers. Both commissions were to be paid upon the entire 40 million (R. 23).

28 million of the 40 million were taken by the holders of the maturing bonds at $96. The syndicate's commission of 2 percent on this amount of bonds was treated as commission. The other 12 million were taken by the syndicate pursuant to its guarantee at $96 less 2 percent, in other words, at $94. The 2-percent commission of the syndicate upon this 12 million of bonds was treated as additional discount. The syndicate managers' commission of 1 percent upon the entire 40 million was treated as commission (R. 24).

The total of the amounts treated as commission, therefore (2% on 28 million, plus 1 percent on 40 million) amounted to $960,000, which, amortized over twenty-five years, gives a yearly amortization of $38,400, which is the amount mentioned in the findings of the Board of Tax Appeals (R. 24, 52).

Conceding that commissions should be treated on the same basis as discount, we submit that in view of the decision of this Court in the *Old Colony* case, *supra,* discount could not properly be allowed on bonds issued prior to 1913. While the Treasury Regulations in their present form permit the deduction of discount on bonds issued prior to 1913, we believe that they are incorrect in that respect. Premiums and discount are both factors in determining the effective rate of interest,[9] and it is anomalous to treat premiums in one way and discount in another. Commissions, and other expenses similar to commissions, are expenses incident to the obtaining of new capital and therefore they are not properly to be regarded as falling entirely in the year in which they occur. However, premiums, discounts, commissions, and incidental expenses all stand on the same footing. Since this Court held that premiums on bonds issued before March 1, 1913, cannot be amortized, it follows that discounts, commissions, and expenses should not be.

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[9] See *Old Colony R. Co.* v. *Commissioner*, *supra*, at pp. 558–559. See also Accounting, Practice & Procedure, by Arthur Lowes Dickinson, pp. 66, 134; Accounting, Theory & Practice, by Roy B. Kester, Vol. II (2d ed.), pp. 367–368; Accounts in Theory and Practice, by Earl A. Saliers, pp. 171–172; Modern Accounting, by Henry Rand Hatfield, pp. 187–188.

CONCLUSION

The decision of the Circuit Court of Appeals with respect to the right of the taxpayer to deduct commissions on bonds issued prior to 1913 should be reversed.

Respectfully submitted.

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OCTOBER 1934.

APPENDIX

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *;
>
> (2) All interest paid or accrued within the taxable year on its indebtedness * * *;
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; * * *

Revenue Act of 1921, c. 136, Sec. 234, 42 Stat. 227, 254, contains substantially identical provisions.

Treasury Regulations 45 (1920 ed.), under the Revenue Act of 1918:

> ART. 544. * * *
>
> (2) (*a*) If bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. * * *
>
> (3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

Treasury Regulations 62 (1922 ed.), under the Revenue Act of 1921, Art. 545, contains identical provisions.

Treasury Regulations 77, under the Revenue Act of 1932:

ART. 68. * * *

(2) (*a*) If bonds are issued by a corporation subsequent to February 28, 1913, at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. * * *

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

(4) (*a*) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was gain or income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. * * *

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